

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:MAN:TL-N-4476-99 & 4478-99
VJGuiliano

date:

to: Chief, Appeals Division, Manhattan District
Attn: A.O. James Borowski

from: District Counsel, Manhattan

subject: [REDACTED] Limited Partnership
(UIL# 48.04-01 R 90)
Taxable Year: [REDACTED]

PROPER BASIS FOR DETERMINING A LESSEE'S INVESTMENT TAX CREDIT ON
A SALE-LEASEBACK OF TRANSITION PROPERTY

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This is in response to your request for assistance whether the partnership's investment tax credit ("ITC") for [REDACTED] should be calculated based on its cost of constructing a hydroelectric plant or the fair market price it received when the plant was sold and leased back by the partnership. Specifically, you asked for our assistance in this matter because the advice we previously provided to the Manhattan District in this case appears to be in conflict with a subsequent Technical Advice Memorandum issued to a different taxpayer by the National Office.

We have discussed this matter with Branch Chief Susan Reaman and Patrick McGroarty from CC:DOM:P&SI:Br5, as well as David Fegan from CC:DOM:FS:P&SI, all of whom agreed that use of the 10 day post-review advice procedure was appropriate here. Since we are coordinating this advice with the National Office under the 10 day post-review procedure, no action should be taken based

upon this advice until the National Office has had the prescribed 10 day period to review and approve this advice.

ISSUE:

Whether pursuant to former I.R.C. § 48, ITC for a seller/lessee of new section 38 transition property should be calculated based on the cost of constructing the property or the fair market value of the property at the time it was sold and leased back by the seller/lessee?

CONCLUSION:

The seller/lessee of new section 38 transition property is entitled to calculate its ITC based on the fair market value of the property at the time of the sale-leaseback under the former section 48(d) election.

FACTS:

On [REDACTED], the [REDACTED] entered into a binding contract with [REDACTED] for the construction of a [REDACTED] plant near the town of [REDACTED]. Actual construction of the plant began in [REDACTED] and the plant's [REDACTED] license was granted by the Federal Energy Regulatory Commission, prior to [REDACTED].

[REDACTED] claimed ITC for qualified progress expenditures during the construction of this plant until [REDACTED]. On that date, [REDACTED] contributed [REDACTED] percent of the plant's assets to its wholly owned subsidiary, the [REDACTED], and sold the remaining [REDACTED] percent to [REDACTED]. Also on [REDACTED], [REDACTED] and [REDACTED] contributed their plant assets into the [REDACTED] Limited Partnership ("partnership"). Under the original partnership agreement, all income, losses and credits of the partnership were to be allocated equally between the two partners.

On [REDACTED], the plant was placed in service and began selling electricity. Within three months, on [REDACTED], the partnership sold the entire plant facility, except for transmission lines, to the [REDACTED], as owner trustee, for \$[REDACTED], which the Service's Engineer has determined was the plant's fair market value. At the same time, the partnership leased the plant back from the purchasers for a term of [REDACTED] years. Under the terms of this lease, the purchasers/lessors agreed to make an election under former section 48(d) to

pass the ITC through to the partnership and that election was properly made for the [REDACTED] taxable year. In addition, on [REDACTED], the partnership agreement was amended with all income, losses and credits of the partnership now being allocated [REDACTED] percent to [REDACTED] and [REDACTED] percent to [REDACTED].¹

For the [REDACTED] taxable year, the partnership calculated its ITC based on \$ [REDACTED], which was the fair market value of the plant (\$ [REDACTED]) plus its basis in the retained transmission lines (\$ [REDACTED]). You have asked us whether the partnership is entitled to use the plant's fair market value (\$ [REDACTED]) to calculate its ITC, instead of its cost in constructing the plant (\$ [REDACTED]).² This change would result in the partnership's claimed ITC being reduced by \$ [REDACTED] ($[REDACTED] \times [REDACTED] \%$). In calculating its ITC for [REDACTED], the Manhattan District has confirmed that the partnership properly recaptured the ITC for qualified progress expenditures previously taken by [REDACTED].

DISCUSSION:

Former section 49(a), added by the Tax Reform Act of 1986, had the effect of terminating ITC for most property placed in service after December 31, 1985. Specifically, this section provided the general rule that for purposes of determining the amount of the investment tax credit under section 46, the regular percentage shall not apply to any property placed in service after December 31, 1985. Former section 49(b), however, provided that this termination would not apply to transition property as defined in former section 49(e). The Manhattan District has already determined that the plant constructed by the partnership meets all the requirements for transition property under former section 49(e), both before and after the sale-leaseback. Accordingly, the sole issue remaining in dispute is the amount of ITC

¹ The Manhattan District has previously determined that this reallocation had substantial economic effect under section 704(b) and allowed it. Accordingly, we are expressing no opinion regarding this reallocation.

² To determine the partnership's cost of constructing the plant, we took the partnership's cost basis for the entire facility per the Service's engineer and subtracted the cost of the retained transmission lines (\$ [REDACTED] - \$ [REDACTED] = \$ [REDACTED]). Please confirm that the partnership's cost basis in the retained transmission lines was \$ [REDACTED].

the partnership is entitled to pass through to its partners for the [REDACTED] taxable year.

On [REDACTED], this office provided written advice to the Manhattan District in which we determined that the partnership was only entitled to calculate its ITC for [REDACTED] based on its cost of constructing the plant, instead of the plant's fair market value at the time of the sale-leaseback. Our advice, which was coordinated with the National Office, was based on the theory that the transitional relief provided by former section 49(b) should be limited to the partnership's basis in the property, since no "detrimental reliance on the pre-1986 law" existed at the time of the sale-leaseback.

Subsequent to our advice, however, the National Office on April 15, 1996 issued a Technical Advice Memorandum (Letter Ruling 9630002) involving a sale-leaseback of transition property where the purchaser/lessor retained the ITC. After analyzing the legislative history behind the transitional relief found in former section 49(b), the National Office determined that the relief provided in this section was not limited by detrimental reliance in sale-leaseback situations. Therefore, the purchaser/lessor was entitled to calculate its ITC based on the transition property's full purchase price in the sale-leaseback.

In reaching the above result, the Technical Advice stated that if the requirements for transition property are met, "(t)he extent of the investment credit available to property qualifying as transitional property must then be determined under the applicable Code provisions." Accordingly, the amount of ITC the partnership is entitled to claim on its transition property (i.e. the plant) must be determined under other provisions of the Code.

As stated above, under the terms of the lease agreement, the purchasers/lessors elected to pass the ITC on the plant through to the partnership under former section 48(d). This section specifically provides that a lessor of property may elect with respect to any "new section 38 property" to treat the lessee as having acquired such property for an amount equal to the fair market value of such property. Furthermore, in defining "new section 38 property", former section 48(b)(2) provides that any section 38 property (i.e. the plant), which is (A) originally placed in service by a person (i.e. the partnership) and (B) sold and leased back by such person within 3 months after the date such property was originally placed in service, such property shall be treated as originally placed in service not earlier than the date on which such property is used under the leaseback. Accordingly, the partnership is entitled to calculate its ITC

based on the fair market value of the plant at the time of the sale-leaseback under the former section 48(d) election.

Finally, it should be mentioned that former section 48(b)(2) does permit a seller/lessee in a sale-leaseback to elect out of the application of that section and thus, not have "new section 38 property". Therefore, a technical argument could be advanced that former section 48(b) is the only method for a lessee to retain its ITC on transition property in a sale-leaseback and the lessee would then be required to compute ITC based on its basis in the property and not the property's fair market value. While this argument could be advanced, we do not recommend pursuing it, especially in light of the fact that a purchaser/lessor in a sale-leaseback would be entitled to ITC on transition property based on its full purchase price.

We again remind you that this advice is subject to National Office review. We will contact you within two weeks of the date of this memorandum to discuss any comments the National Office may have regarding this advice.

This advice relates solely to the facts of this case and should not be used or applied to the facts of any other case. Should you have any questions regarding this memorandum, please contact the undersigned at (212) 264-1595 (X222).

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By: _____
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